DOW THEORY LETTERS INC.

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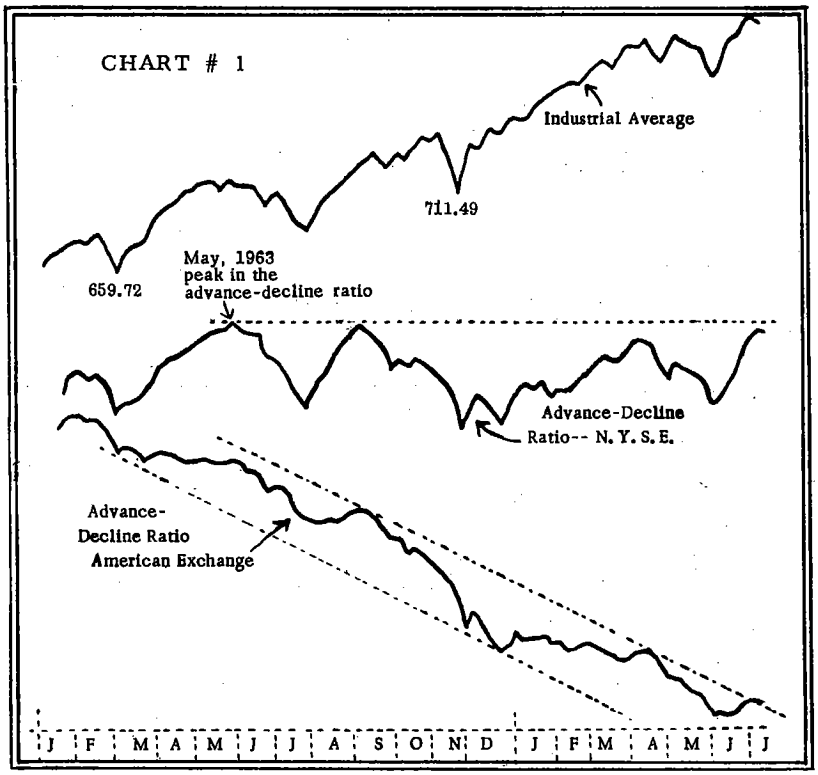
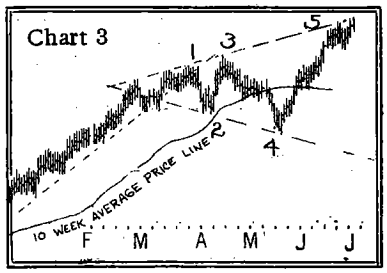
THE MARKET: With the emergence of Barry Goldwater as the leader of the "new" conservative Republican party, with the collapse of the Eastern liberal wing of that party, and with the obvious candidacy of President Johnson as the Democratic standard bearer, the nation is probably now in for one of the roughest political campaigns in years. This will also mark the first time in American history (perhaps a sign of the times) that two Westerners (Southwesterners at that) will oppose each other for the U. S. Presidency.

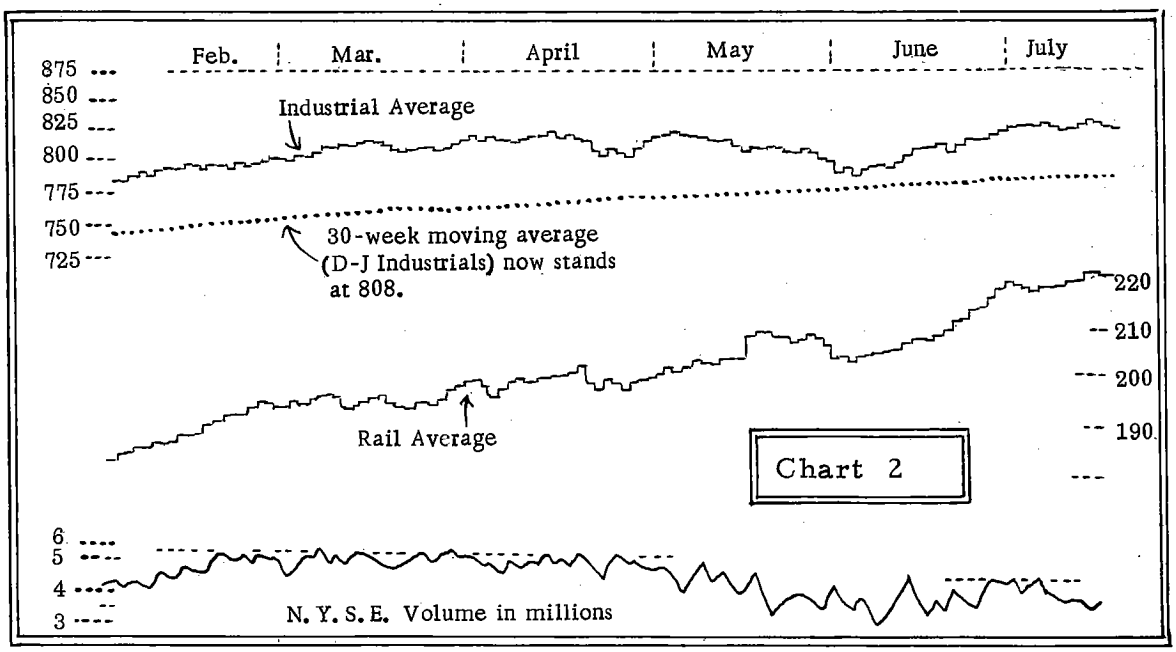
While market analysts lean forward in an effort to detect any slight ripple or trend which might result from all this political "muscle-flexing", another (and much less obvious) trend is developing in a different area — namely, the money market. In my opinion, this latter trend is much more likely to affect the market over the next few months than any probable development in the political arena (see later section of this Letter).



On July 17, the Industrial and Rail Averages closed at 851.35 and 200.98 respectively. Thus historic highs were recorded in both Dow Jones components. As seen on Chart 3, the rise took Industrials to exactly the upper trendline of the extraordinary five-month "broadening formation" (the rare broadening effect is a pattern which has been discussed in detail in recent Letters). From the standpoint of Dow's Theory, it is notable that the advance from the June low has been accompanied by a series of upside confirmations in the two Averages, and this type of action is normally considered to be bullish. The single factor lacking in the advance has been volume. As seen on chart 2, volume during June and July has held persistently below that which accompanied the earlier March-April advance.



In his book, The Dow Theory, Robert Rhea wrote: "In emphasizing the importance of volume, the writer does not, of course, intend to convey the idea that volume of



trading is as important as the movements of the Industrial and Rail Average. The latter are always to be considered of primary importance. Volume is of secondary significance, but it should never be overlooked when a study is being made of the price movement."

A major advance ordinarily begins with professional or informed buying. After the advance has progressed a certain distance it invariably attracts informed selling and public buying. One of the best gauges of public participation is volume, and as a rule, as long as volume continues to expand the advance may be expected to remain intact. During the course of a major advance it is usual for the market to progress a distance beyond the volume peak. In other words, volume usually turns down before price.

On Chart 2 we can see the sharp drop in volume during the June-July rally as contrasted with the volume during March and April. So far, it can be said that the latest rally failed to bring in a "following", and this will be a factor worth watching from here on.

In the last Letter I wrote that I believed the market was at the point where it would either "fish or cut bait". The first faltering came on July 20, but it is too early to tell whether the decline represented a mere minor correction or the beginning of something more important. As seen on Chart 1, the advance-decline ratio on the N.Y.S.E. is now just a fraction below its May, 1963, peak — and in the area where it has turned down on two previous occasions. The A-D ratio on the Amex is still creeping along the top of its long, declining channel. One thing seems certain: if the market is to push out from here and if the Industrial Average is to hurdle the upper trendline of its broadening formation, it is going to take more volume than that which has been seen so far on the June-July rally.

SIGN OF THE TIMES DEPT. The yield on Moody's 125 Stock Average has dropped below the record low of 2.87% recorded in late 1961.

PRESSURE FROM ABROAD: Though few are aware of it, events now taking place in Europe and throughout the free world are rapidly assuming an importance comparable only to the forthcoming U.S. elections. These events have to do with money. I consider the current monetary picture so important that I am taking up a large part of the Letter with a discussion of this situation.

Europe has been enjoying an extended boom, a boom which started shortly after World War II. The great European economic expansion reached white-heat proportions during the early 1960's, but lately the boom has begun to "devour its own tail".

Standards of living have risen dramatically in Europe: new tastes and new demands have swept the Continent. But along with man-power shortages and higher wages, Europeans are now witnessing the specter of inflation. This is a problem with which Europe has, in the past, been very familiar. In some countries inflation is being fought vigorously — primarily in Germany and Switzerland. But in other nations — Italy and England — inflation has been allowed to take its toll. The boom in Italy has literally run out of money. The Italian government, blocked by the strong communist party, has been able to do little in the way of resisting labor's demand for higher wages or corporate desires to raise prices accordingly. The galloping inflation of Italy (a nation which has been termed "the only communist country with a stock market") has resulted in a flight of capital to ports of greater safety. In Italy as everywhere else, capital is mortally afraid of deteriorating currency. Informed money always seeks safety — even at the expense of yield.

Just as important as Italy's problem is the plight of the British pound. The pound is now at its lowest level since 1961 (in relation to the dollar); it is in deep trouble. The consumer boom and the rise of the standard of living in England have resulted in a surge of imports. Imports of course, mean pounds going out of England to pay for merchandise brought in. On top of this, British exports (which bring pounds in as payment for merchandise or services received) have been very sluggish. This has resulted in a long series of "trade gaps" or adverse balance-of-payments for Britain.

The latest figures for June, 1964 (released on July 17), however, proved a surprise even to the pessimists. They showed the British trade gap widening to $293 million dollars — more than twice the figure of May, and the highest adverse gap since the record figure of January, 1964.

What happens now? In the opinion of most knowledgeable observers, England must or should move. She can move in one of two ways: she can raise interest rates and thus attract money to England while at the same time putting a brake on the domestic boom. Or she can devalue the pound — make it worth less in terms of gold and other currencies. This would mean that dollars and other foreign currencies could buy more in England, while at the same time it would take more English pounds to purchase foreign merchandise. Thus, devaluation would have the result of (at least temporarily) helping the British balance-of-payments.

But devaluation or raising interest rates — either one — would also put pressure on the dollar. And with an American Presidential election coming up in October (and strong urging from Treasury Secretary Dillon against raising interest rates), it will be difficult politically for England to move either way (although traditionally, England has moved and moved dramatically when the occasion warranted).

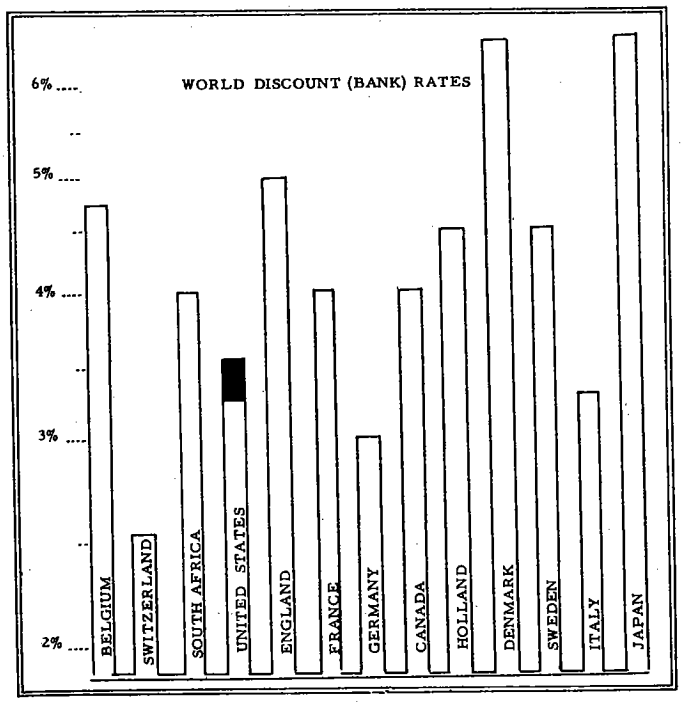
Aggravating the situation in the eyes of investors is the coming British election in October. The Laborites are almost sure to win over the Conservatives, and because Labor is pro-inflation and against higher interest rates, a Labor victory is almost certain to mean more pressure on the pound. For this reason, many observers believe that the British situation is going to

develop into crisis proportions before the British elections in October.

How could this effect us? One very direct effect would be pressure on interest rates. Hardly a week goes by that we do not hear news of a new discount (bank) rate rise in some nation of the Free World. There was a British rise to 5% last February, a Dutch rise to 4.5% in June, a Danish rise to 6.5% in June, and over the past few weeks a rise to 2.5% in Switzerland, 4.75% in Belgium and 4% in South Africa. The implications are clear: European nations mean to fight inflation (despite U.S. appeals) through the classical method of advancing interest rates.

In fact, the Wall Street Journal of July 21 contained an article headlined: "Common Market Aide Says Anti-Inflation Steps Are Too Mild." The article records comments by Robert Marjolin, top economic minister of the Common Market: "Mr. Marjolin told the (Common Market) ministers that they must give 'absolute priority' to problems of achieving internal stability even if this means a slow-down of production and unemployment." In other words, Europe is going to step up its hard money policy. It is therefore obvious that the forces of cheap money (America and England) and the forces of hard money (Europe) are about to meet head on.

As an aside, I might add that if this does occur, one of the immediate victims of the battle will be American savings institutions (perhaps this explains the extreme weakness of the savings & loan stocks — see Letter 256). For with rising European interest rates, there is a strong probability that large chunks of so called "hot money" (sophisticated international money searching for high yields and safety) will seek the increasingly attractive rates available in Europe. Aggravating this trend will be the current stampede by American banks to open branches in Europe. Americans are becoming increasingly aware of world markets (for instance the New York Times now carries daily foreign stock exchange closings), and this interest can be expected to intensify as European interest rates rise.



The accompanying chart traces the dramatic spread of current world bank rates. Note that of 13 leading countries, only three now have lower bank rates than the U.S. Of these three, one is Switzerland, which now discourages foreign money and will not pay interest on foreign accounts. The other is West Germany, with the most favorable trade balance and the hardest currency in the Free World. The third is Italy, which is blocked from taking the needed anti-inflation steps by the powerful Italian communist party.

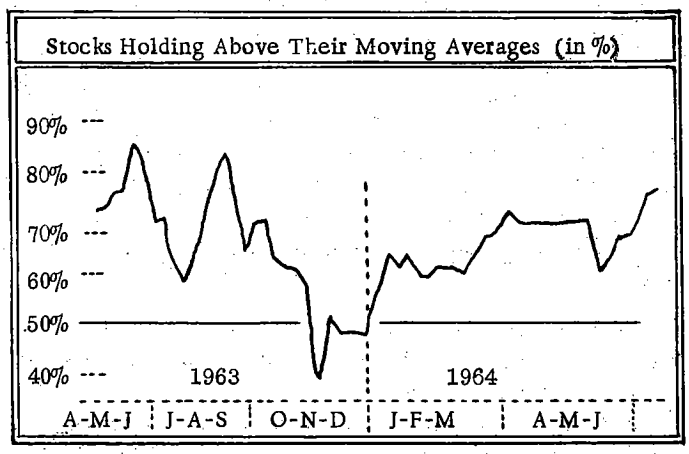
Perhaps the most important relationship on this chart is the yield spread between the U.S. and British bank rate. The yield spread is particularly important because money travels so freely between the two English-speaking nations. The shortest term government debt instrument and the bellwether for the money market both here and in Britain is the 91 day Treasury Bill. At present, an American can purchase a 91 day British Bill which provides a yield of about 4.6% as against a U.S. Treasury Bill which provides a yield of 3.45%. However, there is a risk in buying the British Bill, and that risk is the possible fluctuation in the price of sterling. Therefore, most Americans hedge when they purchase British Treasury Bills. They immediately buy an equal amount of spot sterling and sell an equal amount of sterling for delivery three months away. This hedge is known as a cover, and the cost of covering can vary, but it is usually around 1/2 to 3/4 of a percent. The yield spread between the U.S. Treasury Bill and the comparable British Bill is called the differential, and when the differential already takes into account the cost of the hedge it is known as the covered differential.

When the covered differential is around 1/4% in favor of England, there is a normal (but not large) flow of American funds to England. When the covered differential rises to 1/2% or more, there is traditionally a fairly large movement of funds to England. The covered differential is now about 1/2% in favor of British Bills. However, seasonal influences usually cut into British exports in the second half of any year (thus worsening their balance-of-payments). Furthermore, the coming election may heighten speculation against the pound. In the face of this, it is entirely possible that England will raise her discount rate from the current 5% to perhaps 6% or more. If she does, the covered differential in favor of British Bills could rise to 1% or even 1 1/2%. This would likely attract so much American capital that we would be forced to raise our own (very low) discount rate in self-defense.

That is the picture, and it is an extremely important one. As long as European interest rates continue to rise, direct or indirect pressure on the pound and the dollar will in turn put pressure on U.S. interest rates. This situation, which has been progressing

slowly for many months, is now gathering momentum. Americans and British authorities hope to forestall any possible crisis until after elections in October. Nevertheless, it will pay all readers to watch the bond markets and the money markets with utmost care. For there is no bigger (and less understood) factor in the stock market than money. If trouble now strikes in the money market, it will also hit the stock market — but from a direction which is completely unknown to the vast majority of U.S. investors, both amateur and professional.

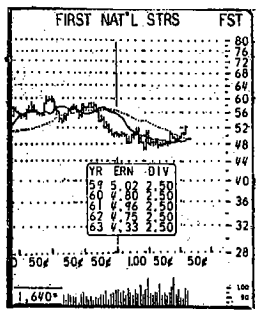
Question: What about buying British Treasury Bills for my account or for my corporation's account? Answer: I see nothing wrong with it. Most investors will buy foreign stocks (Dome Mines, Royal Dutch) with impunity, but they shy away from British Bills. As long as these bills are covered (hedged) for possible fluctuations in sterling, I consider them a prime place for savings. If in the future the British discount rate should go to say 6%, the covered yield on the British Bills would rise to around 5% — an extremely attractive rate. (Any large bank or brokerage house should be able to arrange for the purchase of covered 91 day British Treasury Bills. Furthermore, U.S. corporations may legally purchase these bills, whereas, of course, savings banks and savings departments of commerical banks are not allowed by law to accept funds from corporations — unless they are non-profit corporations).



STOCKS: Of 432 representative stocks tabulated here weekly, 326 (76%) are holding above their long-term moving average, a rise of 1% from last week. As long as the figure holds above 50%, this study remains bullish.

Defensive groups are showing strength, and this includes some of the grocery chains. I recommended Grand Union in Letter 256, and it has pushed slightly higher in a generally sloppy market. First National Stores in the same group is interesting for the following reasons: (1) It is one of the few stocks on the Board which is tracing a "rounding bottom", a pattern usually associated with quiet accumulation. (2) Its relative strength line has been declining for five years (see chart), suggesting that it may be ready to do better than the market for a change. (3) FST pays a well-covered $2.50 dividend, which places it on a yield of almost 5%. (4) The stock has now pushed well above its 200-day moving average (dotted line on small chart). I consider FST one of the most attractive equities at this time.

I reviewed the Cement group in Letter 249. The relative strength of this group is in its sixth year of decline, and most of these stocks are now selling on a yield basis. Although the group has not yet reversed its relative strength downtrend, I believe stocks in the group are being accumulated. Lone Star has held in a tight range over the past month, and in my opinion the stock represents a value around 22. A second stock which represents unusual value at this time is Symington Wayne. Earnings are good and the dividend is attractive. With the current search for values, SZ could generate interest and even develop a following (something it has never done before).



Large chart of FST courtesy of Traders Research, 1431 Pearl Avenue, Alton, Illinois 62003.
Three small charts courtesy of Quote Digest, 110 North Lorraine, Wichita, Kansas.